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June 9, 1992

via Hand Delivery

Hon. Donna R. Searcy
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

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Re: Ex Parte Presentation
Regarding CC Docket No. 92-101

Dear Ms. Searcy:

In CC Docket No. 92-101, the Federal Communications Commission is evaluating tariffs filed by the Bell Atlantic Telephone Companies (Trans. No. 497), US West Communications, Inc. (Trans. No. 246) and Pacific Bell (Trans. No. 1579) implementing the Statement of Financial Accounting Standards - 106 (SFAS-106), "Employers Accounting for Postretirement Benefits Other than Pensions" (OPEB). In particular, the Commission is investigating the proper price caps classification of the cost changes associated with the implementation of SFAS-106 and the calculation and allocation of those cost changes.

The California Public Utilities Commission's Division of Ratepayer Advocates (DRA) has prepared a voluminous report addressing the ratemaking impacts of SFAS-106. The report, entitled "Report on Statement of Financial Accounting Standards No. 106" (DRA Report), includes an extensive "background" section, thorough analysis of the myriad issues regarding the accrual accounting treatment and the ratemaking ramifications of the implementation of SFAS-106 and a series of provocative conclusions and recommendations. The DRA Report is also supported by extensive factual and analytical appendices.

The Ad Hoc Telecommunications Users Committee believes that the inclusion of the DRA Report therein would enhance the record in CC Docket No. 92-101 and assist the Commission in determining the proper price caps treatment of SFAS-106-driven cost

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changes. Accordingly, the Ad Hoc Committee hereby submits the DRA Report for inclusion in the record in CC Docket No. 92-101.

Respectfully submitted,

Charles C. Hunter
Attorney for the Ad Hoc
Telecommunications Users
Committee

CCH/rs
Enclosure
cc (w/enc.): Mary L. Brown

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Exhibit No. 75
Commissioner:
Adm. Law Judge: Michael J. Galvin

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CALIFORNIA PUBLIC UTILITIES COMMISSION

Division of Ratepayer Advocates

PHASE II TESTIMONY

REPORT ON STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 106

I.90-07-037

San Francisco, California

November 15, 1991

MEMORANDUM

This report was prepared by the California Public Utilities Commission's Division of Ratepayer Advocates (DRA). Mark Loy, Public Utilities Regulatory Program Specialist I, was the Project Manager and was responsible for the overall coordination of the analysis and production of this report. The following list identifies the authors of specific sections of this report:

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PHASE II TESTIMONY OF THE DIVISION OF RATEPAYER ADVOCATES

I. EXECUTIVE SUMMARY

A. Introduction

Investigation on this Commission's own motion I.90-07-037 ["this OII"] was opened to gather information and to analyze the ratemaking impacts of the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 106 (SFAS No. 106), Employers' Accounting for Postretirement Benefits Other than Pensions (PBOPs). The purpose of this OII is to consider the ratemaking effects of PBOPs obligations and to establish consistent general policies and procedures to be applied to all utilities. This OII is separated into two phases. Phase I considered the benefits and detriments of advance funding, the timing of rate recovery for prefunding PBOPs, and the methods of ensuring that those funds are used for PBOPs. Phase I culminated with the issuance of D.91-07-006, which authorized limited advance funding of PBOPs obligations because of the net ratepayer savings attributable to the accumulation of tax-free earnings on fund investments. Phase II will examine the impact of the new PBOPs accounting for ratemaking and regulatory accounting purposes. The scope of this phase is much broader than the first because all issues regarding accrual accounting treatment and ratemaking ramifications will be scrutinized.

In order to facilitate the appreciation and the comprehension of this important new accounting standard, the Division of Ratepayer Advocates (DRA) has prepared and included an extensive "background" section. This section serves to set the technical tone of these comments and identifies and defines the issues which are addressed in the body of these comments. Although this background section does not contain DRA conclusions and recommendations, it does contain definitions and explanations which are critical to understanding how DRA arrived at its conclusions and recommendations.

B. General Comments

DRA is concerned that many of the respondent utilities' Phase II testimony and comments are based on conclusions in the Phase I Decision (D.91-07-006) which are taken out of context. More specifically, the scope of Phase I (I.90-07-037) was limited to determining whether or not there is a clear ratepayer benefit to prefunding now versus prefunding later. This prohibited the inclusion of any cash flow analysis of SFAS No. 106 versus any alternative regulatory accounting into the record. This procedural approach is clearly evident in the interpretations in the Phase I Decision (D.91-07-006) of Pacific Bell's (Pacific) and GTE California's (GTEC) exhibits and testimony on the net present value benefits of prefunding (see next paragraph). DRA strongly urges this Commission not to give any weight to Phase II arguments relying upon the Phase I Decision unless they also explicitly address the broader scope of Phase II because Phase I, by definition, did not consider SFAS No. 106 or alternatives to prefunding.

As stated above, DRA is concerned that the Phase I Decision is premised on interpretations by Pacific Bell and GTE California testimony and comments which render its findings of fact, conclusions, and orders inappropriate for use in Phase II. More specifically, in response to DRA's criticism that no comparisons between pay-as-you-go and prefunding were made, this Commission found (D.91-07-037, pp. 16-17) that these utilities' had conducted sufficient net present value analyses:

> The "certain benefits" called for in the investigation are not defined; however, both GTEC and Pacific Bell demonstrated the existence of monetary benefits from prefunding. Whether these monetary benefits accrue to the ratepayers or ultimately result in lower rates depends on our determination as to whether or to what extent Z factor treatment is afforded.

This conclusion does not rely on any comparisons of pay-as-you-go to prefunding. It is based on certain exhibits and testimony sponsored by Pacific Bell and GTEC <u>and on the adoption by this Commission of SFAS No. 106 for ratemaking purposes.</u> First, Pacific Bell's Brian Thorne was very adamant that Pacific Bell had not conducted any comparisons between prefunding and pay-as-you-go because it was unnecessary (Tr 1:32, 51, and 65). In fact, ALJ Galvin's entire line of questioning regarding the benefits of prefunding was premised on the assumption that prefunding is adopted for ratemaking purposes (Tr 1:65). Similarly, GTEC's net present value analysis (Exhibit No. 14, Exhibit B and Exhibit No. 16) is predicated on the assumption that SFAS No. 106 is adopted for ratemaking purposes. This is implicitly evidenced in notes (2) and (3) of Exhibit No. 16 (a.k.a. revised Exhibit B of Exhibit No. 14) which pertains to all values contained in the entire document:

> Years 1991 and 1992 represent the incremental impac[t] of prefunding.
>
> Years 1993 and forward represent the incremental impact of accrual accounting over pay-as-you-go accounting.

It is obvious that quantitative comparisons which exclude pay-as-you-go values do not reflect the dollar difference between pay-as-you-go accounting versus accrual accounting. Therefore, as with Pacific Bell's analysis, this is merely comparing prefunding now (i.e, 1991) to prefunding later (i.e., 1993)[1]. However, from both utilities' showings it is very easy to deduce the result of a comparison between pay-as-you-go funding and accrual accounting with advance funding. **Since both present value comparisons represent the incremental increase in costs of prefunding over pay-as-you-go, it is obvious that all values in**

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1. GTEC mislabeled the funding alternatives reflected in Exhibit No. 16 and Exhibit B of Exhibit No. 14. Most specifically, GTEC incorrectly labeled prefunding beginning in 1993, "No Prefunding", and prefunding beginning in 1991, "Prefunding". Thus, neither data series in GTEC's exhibits reflect no prefunding.

these exhibits represent the net cost increase to ratepayers of switching to accrual accounting with prefunding.

In this regard, DRA cannot overemphasize the importance of comparing alternatives before authorizing a specific course of action. First, there is clear Commission precedent for comparative analysis of alternatives in general rate case proceedings (e.g., conservation programs), prudency reviews (e.g., gain on sale of plant), and applications for necessity and convenience (e.g., major plant additions). Indeed, it is this very practice of scrutinizing competing alternatives that constitutes the essence of the regulatory process and replaces the crucial role of the market place in competitive, nonregulated industries. However, there is an additional potential danger should the Commission rely upon the Phase I Decision to justify accrual accounting with advance funding in Phase II. It would doom Phase II to a tautological outcome -- rejection of pay-as-you-go funding and adoption of prefunding based on the conclusion that prefunding now is preferable to prefunding later. Failure, in this proceeding, to thoroughly and rigorously analyze all alternatives could result in unwarranted and unnecessary financial burdens being placed on ratepayers. This outcome would be a disservice to the public.

C. Division of Ratepayer Advocates' Findings, Conclusions, and Recommendations

- o Pay-As-You-Go funding is the most cost effective ratemaking alternative from a ratepayer standpoint.
- o Pay-As-You-Go funding is the most sound regulatory accounting treatment for PBOPs.
- o DRA recommends that the Commission **reject** Statement of Accounting Standards No. 106 for ratemaking purposes and as the official regulatory accounting treatment for PBOPs.
- o Pay-As-You-Go is consistent with existing Internal Revenue Service and Employee Retiree Income Security Act of 1974 (IRS/ERISA) accounting for PBOPs.

- IRS/ERISA regulations together with Statement of Financial Accounting Standards No. 71 (SFAS No. 71) could protect regulated utilities' earnings, employee benefits, and creditworthiness from any adverse impacts attributable to not adopting SFAS No. 106.
- DRA strongly urges this Commission to set revenue requirements on a case-by-case basis (i.e., in general rate cases) and not in generic proceedings.
- SFAS No. 106 does not require employers to prefund their PBOPs obligations.
- The FASB does not regulate employee benefits and SFAS No. 106 is not intended for use in regulating employee benefits.
- The CPUC is not required to adopt changes in Generally Accepted Accounting Practices (GAAP) for ratemaking purposes.
- The FASB has issued an <u>Exposure Draft</u> on income taxes which could significantly offset the level of costs reported under SFAS No. 106.
- If the Commission adopts some form of prefunding in this proceeding, then rate recovery for the prefunding of PBOPs should be granted if, and only if, the following prerequisites are satisfied:
    1) Utilities demonstrate that they have diligently analyzed and pursued all available alternatives to rate increases, including health cost containment and benefit plan restructuring.
    2) Utilities perform economic analyses which clearly demonstrate quantitatively that 1) advance funding results in the lowest revenue requirement and 2) advance funding results in a lower cost of capital.
    3) The only acceptable funding vehicles are those where the contributions are tax-deductible and earnings accumulate tax-free are used.
    4) Shareholders and utility managements assume the responsibility for all risks, penalties, and damages and abuses and/or missed opportunities

attendant to their PBOPs contributions for which it can be shown were the result of their decisions and actions.

5) Utilities be required to annually submit a complete copy of the official actuarial report which sets forth the PBOPs annual expense, contributions, liabilities, accumulated assets, assumptions, and actuarial accounting methods.

6) DRA recommends that plan or trust agreements which include clauses that permit the reversion of PBOPs assets to the employer not be granted rate recovery.

7) Utilities must establish and maintain segregated accounting for regulated and nonregulated operations.

8) Ratepayers must be fully compensated for any and all PBOPs revenue requirements that are not used for advance funding of PBOPs obligations.

- Utilities should be required to report substantive changes to their PBOPs plans to DRA and the Commission's Advisory and Compliance Division (CACD) on a routine basis.
- The respondent utilities have not justified their PBOPs revenue requirements:

  1) Respondent Utilities have not adequately analyzed all reasonable alternatives.

  2) Respondent utilities have not provided any credible evidence that SFAS No. 106 will impact cash flow and credit ratings.

  3) Respondent utilities have not provided any evidence that their estimates of PBOPs revenue requirements are related to the provisions in labor agreements, employee handbooks, and historical claims experience.

  4) Respondent utilities have not adequately addressed how other financial accounting

standards will affect financial reporting under SFAS No. 106.

II. BACKGROUND

In December 1990, the Financial Accounting Standards Board (FASB)[2] issued a finalized Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, which promulgated the accounting methods and the standards of financial reporting for PBOPs.[3] This statement was the culmination of efforts initiated in 1974 by the FASB to improve the usefulness and accuracy of accounting for pensions and PBOPs.[4]

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2. FASB is the nongovernmental, independent organization which is entrusted by the accounting profession with the responsibility of establishing and improving financial accounting and reporting "for the guidance and education of the public, including issuers, auditors, and users of financial statements" (FASB **Rules of Procedure,** page 2). In fulfilling this responsibility (i.e., "its mission") the FASB follows certain precepts, including the authority to promulgate standards of financial accounting. Under this precept, the FASB has issued a body of standards commonly known as the promulgated Generally Accepted Accounting Principles (GAAP). GAAP constitutes the basis for the preparation of external financial statements and reports and for the scope of external audits of most business and nonbusiness organizations in the United States.

3. PBOPs include the following types of retiree benefits: health care, dental care, vision care, life insurance, utility service subsidies, legal services, and death benefits.

4. In 1979, the FASB added PBOPs to its pensions project. In 1984, accounting for PBOPs was identified as a project separate from pensions. In February of 1989, approximately three years after the issuance of Statement of Financial Accounting Standards No. 87, **Employers' Accounting for Pensions,** the FASB issued an Exposure Draft, "Employers' Accounting for Postretirement Benefits Other Than Pensions." This was followed by a lengthy period of public participation in which the FASB, in an usual course of action, actively solicited input from interested groups such as actuaries, analysts, business executives, financial statement preparers, and auditors.

These actions by FASB were precipitated by concerns raised by the accounting profession, labor, financial analysts, and plan sponsors regarding the integrity of accounting for PBOPs on a pay-as-you-go (cash) basis, the prevailing accounting treatment. More specifically, many felt that as the prevalence and magnitude of employers' promises to provide PBOPs increased,[5] existing financial reporting was failing to identify and to accurately measure the financial ramifications of those promises. These failures could have serious and detrimental affects on PBOPs affordability, the design and adequacy of benefits, the employer's right to modify benefits, funding capabilities, creditworthiness, and equity values. Over the course of the FASB's deliberations on this subject, a consensus of the accounting and financial professions and in the business community concluded that PBOPs constitute deferred compensation, whereby an employer promises to exchange future benefits for employees' current services. This form of accrual accounting results in a dramatic change from existing accounting because the costs of providing these benefits would be recognized over employees' active service lives rather than when benefits were actually paid.

After more than a decade of analysis and proceedings, the FASB has concluded that implementation of SFAS No. 106 (SFAS No. 106, paragraph numbers 4 and 5) "should result in more useful and representationally faithful financial statements. However, this Statement is not likely to be the final step in the evolution of more useful accounting for postretirement benefit arrangements."

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5. The PBOPs financial liability and legal obligations have grown enormously over the last twenty years due to expansion of PBOPs coverage in labor agreements, the aging of the general United States population, rapidly increasing medical inflation rates, cost shifting from government to the private sector, and the success of modern medicine at extending and improving people's lives.

Moreover, FASB's "objectives in issuing this Statement are to improve employers' financial reporting for postretirement benefits in the following manner:

a. To enhance the relevance and representational faithfulness of the employer's reported results of operations
b. To enhance the relevance and representational faithfulness of the employer's statement of financial position
c. To enhance the ability of users of the employer's financial statements to understand the extent and effects of the employer's undertaking to provide postretirement benefits to its employees
d. To improve the understandability and comparability of amounts reported

Despite the controversy and alarm surrounding the implementation of SFAS No. 106, the new accounting for PBOPs is not revolutionary. In concept and by design, SFAS No. 106 is very similar to accounting for pensions, Statement of Financial Accounting Standard No. 87, **Employers' Accounting for Pensions** (SFAS No. 87), and Statement of Financial Accounting Standard No. 88, **Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits** (SFAS No. 88). (See SFAS No. 106, "Similarity to Pension Accounting"[6].) First of all, the statements affirm basic

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6. "The provisions of this Statement [SFAS No. 106] are similar, in many respects, to those in FASB Statements No. 87, **Employers' Accounting for Pensions**, and No. 88, **Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.** To the extent the promise to provide pension benefits and the promise to provide postretirement benefits are similar, the provisions of this Statement are similar to those prescribed by Statements 87 and 88; different accounting treatment is prescribed only when the Board [FASB] has concluded that there is a compelling reason for different treatment. Appendix B identifies the major similarities and differences between this Statement and employers' accounting for pensions."

accounting premises: 1) that accrual accounting provides more relevant and useful information than cash basis accounting, and 2) that costs be consistently matched with related revenues. In addition, SFAS No. 106, Appendix B, identifies and describes how the two statements use consistent terminology and methods to measure and to identify the financial effects of an employer's benefit obligation. For example, the basis for accounting, the attribution method and period, service cost (also see SFAS No. 106, paragraph nos 166-171), and the disclosure requirements in SFAS No. 106 parallel those in SFAS No. 87. Benefit settlements, curtailments, termination benefits, and disposal of a segment or a portion of a line of business are the same under SFAS Nos. 106 and 88. Also, both SFAS No. 87 (paragraphs 80-83) and SFAS No. 106 (paragraphs 148-150) reaffirm the Accounting Principles Board's conclusion, found in APB No. 8 (issued in November 1966), that funding should not necessarily be used as the basis for accounting recognition of the cost.[7] Similarly, both statements reaffirm the conclusion that the definition of a financial liability is not dependent on the legal status of an obligation (SFAS No. 106, paragraph nos. 152-158 and SFAS No. 87, paragraph nos. 153-154). Finally, both SFAS Nos. 87 and 106 recognize only one actuarial cost method (projected unit credit or the benefits-to-years-of-service approach)[8] for use in

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7. "The question of when to fund the obligation is not an accounting issue. It is a financing question that is properly influenced by many factors (such as tax considerations and the availability of attractive alternative investments) that are unrelated to how the postretirement benefit obligation is incurred." (SFAS No. 106, paragraph no. 150 and SFAS No. 87, paragraph no. 81.)

8. This is not consistent with the Internal Revenue Service and Employee Retirement Income Security Act of 1974 (ERISA) statutes which recognize six different actuarial cost methods (United States Code Annotated, Title 29, "Labor", §1002 (31)) for the determination of tax deductible pension and PBOPs funding limits (ERISA §301-306 and Internal Revenue Code §415,416,419,420).

attributing PBOPs (SFAS No. 87, paragraph nos. 40-42; SFAS No. 106, paragraph nos. 43-44).

While there are similarities, as described above, there are also significant differences between accounting for PBOPs and accounting for pensions. Some of these differences are due to the constructs of the statements themselves and others are attributable to the legal, financial, regulatory, and labor aspects surrounding the different types of benefit promises. As set forth in Appendix B of SFAS No. 106, accounting for PBOPs, unlike accounting for pensions, does not require recognition of a minimum liability, permits immediate recognition of the Transition Obligation, sets the amortization period at 20 years rather than 15 years, and has additional disclosure requirements regarding the health cost trend rate, the sensitivity of the valuation to changes in this trend rate, and a description of the substantive plan. In addition, SFAS No. 106 requires the estimation of a health cost trend rate. (Also, see Appendix 1 of these Comments).

These inconsistencies are relatively inconsequential when compared to the nonaccounting aspects. Historically, the nature of a PBOPs promise has been perceived very differently from those for pensions. This has resulted in tremendous inconsistencies in the legal issues, financing, credit and equity issues, labor relations, regulation, and the accounting (which will be resolved upon the implementation of SFAS No. 106) for PBOPs.

In the past, PBOPs were commonly understood to be benefit promises that could be changed at the will of the employer and that did not take effect until the employee retired. In practice this manifests itself in 1) **the total lack of benefit formulae for determining the value of PBOPs earned, and 2) the absence of any legal requirement for advance funding of PBOPs, both of which are mandated for pension plans under IRS/ERISA**. In addition, PBOPs, and retiree medical costs in particular, are much more complex than pensions (SFAS No. 106, paragraph no. 195). More specifically, sociodemographics and past experience, the extent and types of coverage provided, the eligibility requirements, the cost-sharing provisions between employer and employee, the risk-sharing arrangements between employer and provider, and the impact of public and private policy vary considerably **within plans** (i.e., options), **from plan to plan, and from employer to employer.**

For retiree medical benefits, this complexity is exacerbated by the volatile effects of medical inflation -- which can be further compounded by changes in benefit provisions. For example, pension costs are almost always a direct function of payroll, which, in turn, is directly related to inflation (e.g., as reflected in the Consumer Price Index - Wage Earners). Consumer inflation is relatively stable, from year to year, and recorded data and reliable forecasts are readily available. Retiree medical costs, on the other hand, are the result of utilization by the participants, sociodemographic changes, changes in plan design and coverage, changes due to labor negotiations, medical inflation, medical technology, changes in public and private policy, etc. Consequently, it is not unusual for medical care inflation to be negative 5 percent one year and positive 14 percent the next. Economy-wide measures of medical inflation do not prove to be reliable forecasts of medical costs at the level of the firm[9]. These practical problems and the conventional perceptions of the PBOPs promise made the pay-as-you-go accounting attractive and served to justify its use.

In practical implementation, therefore, PBOPs accrual accounting is worlds apart from pension accrual accounting. The implications for the calculation of the SFAS No. 106 Health Care Cost Trend rate, and resultant annual expense and total liability

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9. A case in point is the treatment of medical costs in recent Commission attrition proceedings. In these filings, a unique, special allowance was calculated for the revenue requirement for health care expenses because the labor and nonlabor inflation factors and growth components were not adequately capturing increases in medical costs. More specifically, a utility-specific medical inflation rate and component were derived (using recorded data) for incorporation into the attrition allowance formula.

are obvious. Indeed, in addition to the concerns raised about volatility and reliability with respect to FASB's measures of interest rates and assets, PBOPs accounting involves considerable volatility inherent in the incidence of health care costs (SFAS No. 106, paragraph nos. 38-41).[10] This predicament and the general lack of expertise in estimating medical costs have caused actuaries and financial managers considerable anxiety and resulted in an unusual decision by the FASB to delay, by one year, the effective date of the PBOPs accounting (SFAS No. 106, paragraph nos. 388-389).

Now that the unique nature of PBOPs benefits and accounting has been reviewed, it is necessary to discuss the remaining nonaccounting ramifications of SFAS No. 106.

Regulation of PBOPs Obligations: PBOPs and pensions are generally covered under ERISA. ERISA requires stringent vesting, funding, termination, curtailment, and fiduciary standards to protect employees' pension benefits, but does not prescribe

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10. "Retiree Medical Liabilities and FAS 106", pg. 35, **Standard & Poor's Creditweek**, May 20, 1991. "Another important difference with pension accounting will be the level of confidence that can be placed in the disclosed liability and expense amounts.... FAS106 will also entail the use of additional, speculative assumptions about changes in health-care costs, taking into account such considerations as changes in health-care inflation, health-care utilization or delivery patterns, medical technology, and the status of plan participants. Reported [PBOPs] liability and expense amounts will be highly sensitive to differences in the underlying assumptions."

Also, see Coopers & Lybrand and Hewitt Associates, Non-Pension Benefits for Retired Employees: Study of Benefits and Accounting Practices (Morristown, New Jersey: Financial Executives Research Foundation, 1987), pp. 45-49, and Benjamin S. Neuhausen and Richard Ostuw, "Employers' Accounting for Postretirement Benefits: Gains and Losses, Corridors, and Volatility", Highlights of Financial Reporting Issues, pp. 5-9, published by the Financial Accounting Standards Board, May 21, 1990.

comparable safeguards for PBOPs.[11] Furthermore, for PBOPs, there is no counterpart to the protections provided by the Pension Benefit Guarantee Corporation. This lack of regulation and enforcement means that, unlike pensions, there are no laws requiring employers to prefund PBOPs obligations and that IRS/ERISA recognizes PBOPs obligations on a cash basis. This has provided employers broad flexibility with which to sponsor, manage, and fund PBOPs, especially collectively bargained plans. However, IRS/ERISA does require employers to fulfill certain disclosure and funding standards before PBOPs prefunding can be declared as a tax deduction (IRC § 89, 401, 419, 420; ERISA § 102(a)(1), 301-306; Department of Labor (DOL) regulations § 2520.103).

Legal Protection of PBOPs:[12] The lack of regulation by the Department of Labor (DOL) and under IRS/ERISA has prompted many employers to assume that PBOPs are, to a large extent, discretionary and subject to change depending on the financial health of the firm. However, developments in the courts and in federal legislation[13] are compelling labor and management to gain greater comprehension of an employer's legal obligations and the employer's ability to control them, especially, via terminations and curtailments of benefits. In particular,

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11. Employee Benefit Research Institute, Retiree Health Benefits: What Is the Promise? (Washington DC: Employee Benefit and Research Institute, 1989), pp.53-55,71-72. Also compare IRC § 404, pension funding limits, with IRC § 419, 419A, and 420, funding limits for welfare benefit plans.

12. SFAS No. 106 is consistent with FASB Concepts Statement No. 6, paragraphs 5 and 6. It defines a financial liability as not being dependent on the legal status of the PBOPs obligation. It also recognizes that the promise to provide PBOPs meets the accounting definition of a liability regardless of the employer's ability to eliminate or otherwise modify retiree benefits.

13. The recently enacted Retiree Benefits Bankruptcy Protection Act requires companies, that have filed for bankruptcy under Chapter 11 of the Bankruptcy Act of 1980, to provide for retiree health, disability, and death benefits before a reorganization can be approved.

because retirees have no statutory right to vested interminable PBOPs under ERISA, employees have sought legal remedies with the courts, which have gone to contract law as the basis for their decisions. The courts have looked at the intent of the parties involved as reflected in the written provisions of the plan, collective bargaining agreements, documents distributed to employees, discussions with employees just prior to retirement, and past patterns of conduct. Generally, the courts have been persuaded by the existence, or lack thereof, of unambiguous language reserving the employer's right to modify the terms of the retirement plans. Those employers who cannot show that they did not specifically reserve the right to change plan terms have been bound to the original terms of the plan. In addition, court decisions indicate that employers may have a greater ability to change PBOPs being earned by active employees than those already being enjoyed by existing retirees.[14] Unfortunately, many crucial issues remain unsettled; therefore, litigation will continue to be the major remedy for PBOPs disputes.

Employee Relations: In recent years, employees have really been feeling the economic bite of PBOPs liabilities as employers turn to more drastic measures for meeting rapidly escalating benefit obligations. SFAS No. 106 will give employers a critical incentive to reduce PBOPs and/or to shift the cost burden to employees and retirees. We have already seen examples of employers who have reduced active and retiree benefits or who have considered changes to their plans as a response to PBOPs

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14. International Union v. Yard-Man Inc., 716 F2d 1476 (6th Cir. 1983); Hansen v. White Farm Equipment Co., 42 BR 1005 (ND Ohio 1984); Eardman v. Bethlehem Steel Corp. Welfare Benefit Plans, 607 F. Supp. 196 (WDNY 1984); Musto v. American General Corp., 861 F2d 897 (6th Cir. 1988); Moore v. Metropolitan Life Insurance Co., 856 F2d 488 (2nd Cir. 1988); Alday v. Container Corporation of America (1990).

prefunding.[15] Employees, and unions in particular, will continue to fight to preserve and increase benefits. In this regard, retiree benefits are a particularly contentious topic. Companies may find it politically advantageous to phase in any benefit reductions or confine changes to future retirees only.

Creditworthiness: PBOPs obligations vary dramatically from one firm to another. For those companies where PBOPs represent a very substantial use of cash, SFAS No. 106 may have an adverse affect on credit rating, especially for companies at the margin. The increase in reported PBOPs expenses and the cumulative liability may cause new issue borrowing spreads, both within a credit rating and between credit ratings, to widen. These new disclosures may cause certain companies to breach net worth and/or coverage requirements in their debt agreements and this, in turn, could impair their ability to obtain new debt.

Despite these adverse possibilities, the major credit rating agencies do not seem to be impressed with the usefulness or relevance of SFAS No. 106 in determining creditworthiness.[16] Standard & Poor's (S&P) reported that "implementation of this accounting change is not expected to have any widespread impact on debt ratings, since cash flow will not be affected directly, and S&P already assesses the obligation to provide [PBOPs] when determining industrial companies' credit quality."[17] Similarly, Moody's has stated that "rating changes are not anticipated as a

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15. Pacific Bell negotiated annual and lifetime maximum coverage for its active and retiree medical benefits just prior to establishing and contributing funds to a PBOPs trust. International Business Machines and Data General Corporation also restructured their health benefits to defined benefit plans before funding their PBOPs obligations.

16. **Standard & Poor's Creditweek**, September 11, 1989; **Moody's Special Comments, FAS 106 -- Moody's Analytical Perspective**, March 1991; "Retiree Medical Liabilities and FAS106", **Standard & Poor's Creditweek**, May 20, 1991.

17. "Retiree Medical Liabilities and FAS 106", pg. 35, **Standard & Poor's Creditweek**, May 20, 1991.